

SICPA

MASSACHUSETTS

Illegal Tobacco Commission

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Enabling trust

AGENDA

- I. History of the Massachusetts Tax Stamping Program
- II. Current Environment
- III. Best Practices
 - A. Regulations
 - B. Oversight & Penalties
 - C. Enhanced Enforcement Tool // SICPATRACE®
 - Overview
 - Benefits
- IV. Additional Services for Consideration
- V. Market Trends
- VI. Best Practices Summary



I. HISTORY OF THE MASSACHUSETTS TAX STAMPING PROGRAM

HISTORY OF THE MASSACHUSETTS TAX STAMPING PROGRAM



1997: introduced heat-applied cigarette tax stamp

1998: color change

1999: added semi-covert security feature

2002: color change

2005: added semi-covert and covert security features

2008: color change

2009: state initiated procurement for encrypted tax stamp



2010: migrated to track & trace, encrypted stamp and reporting platform (SICPATRACE®)

2011: deployed upgraded enforcement tools (SM45)



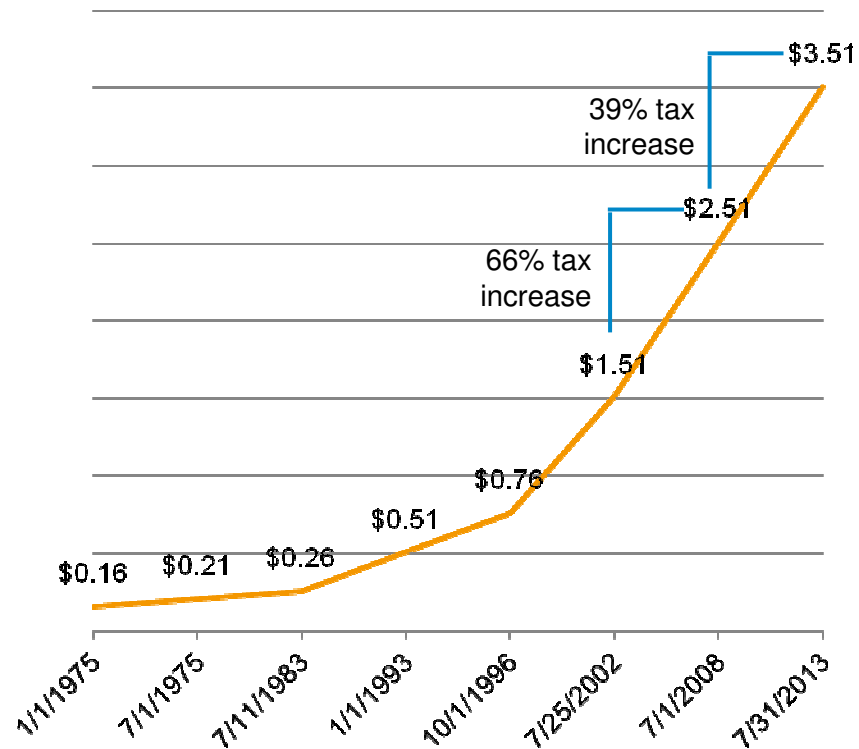
2013: Tax rate change (\$2.51 to \$3.51); color change



II. CURRENT ENVIRONMENT

MASSACHUSETTS CIGARETTE TAX RATES AND VOLUMES OVER THE YEARS

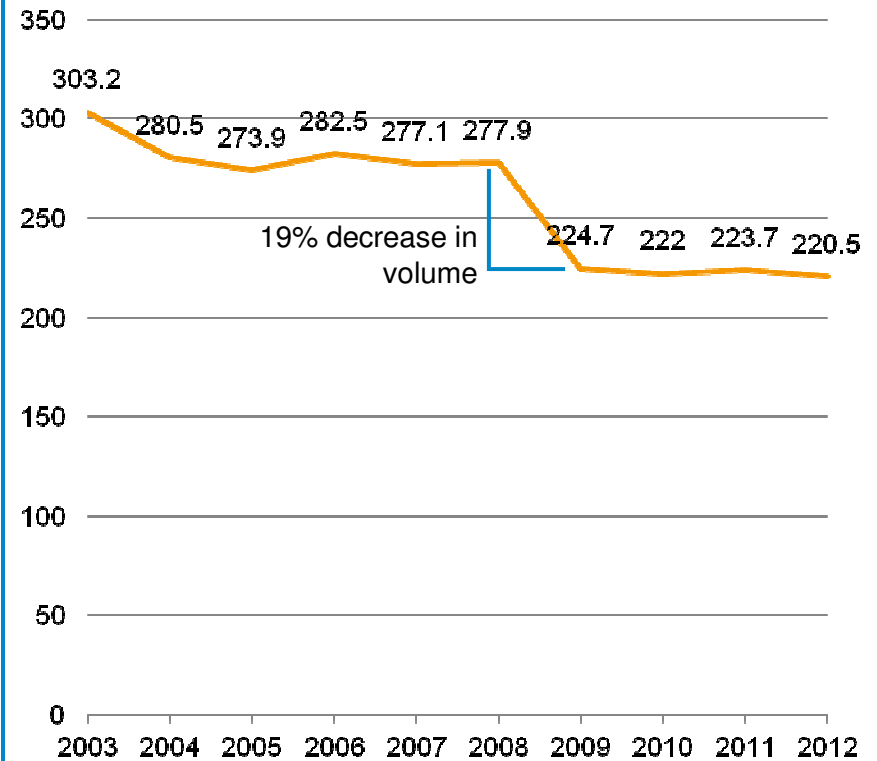
Tax Rate per Pack



2010:
7th largest
excise tax rate

2013:
2nd largest excise
tax rate after NY

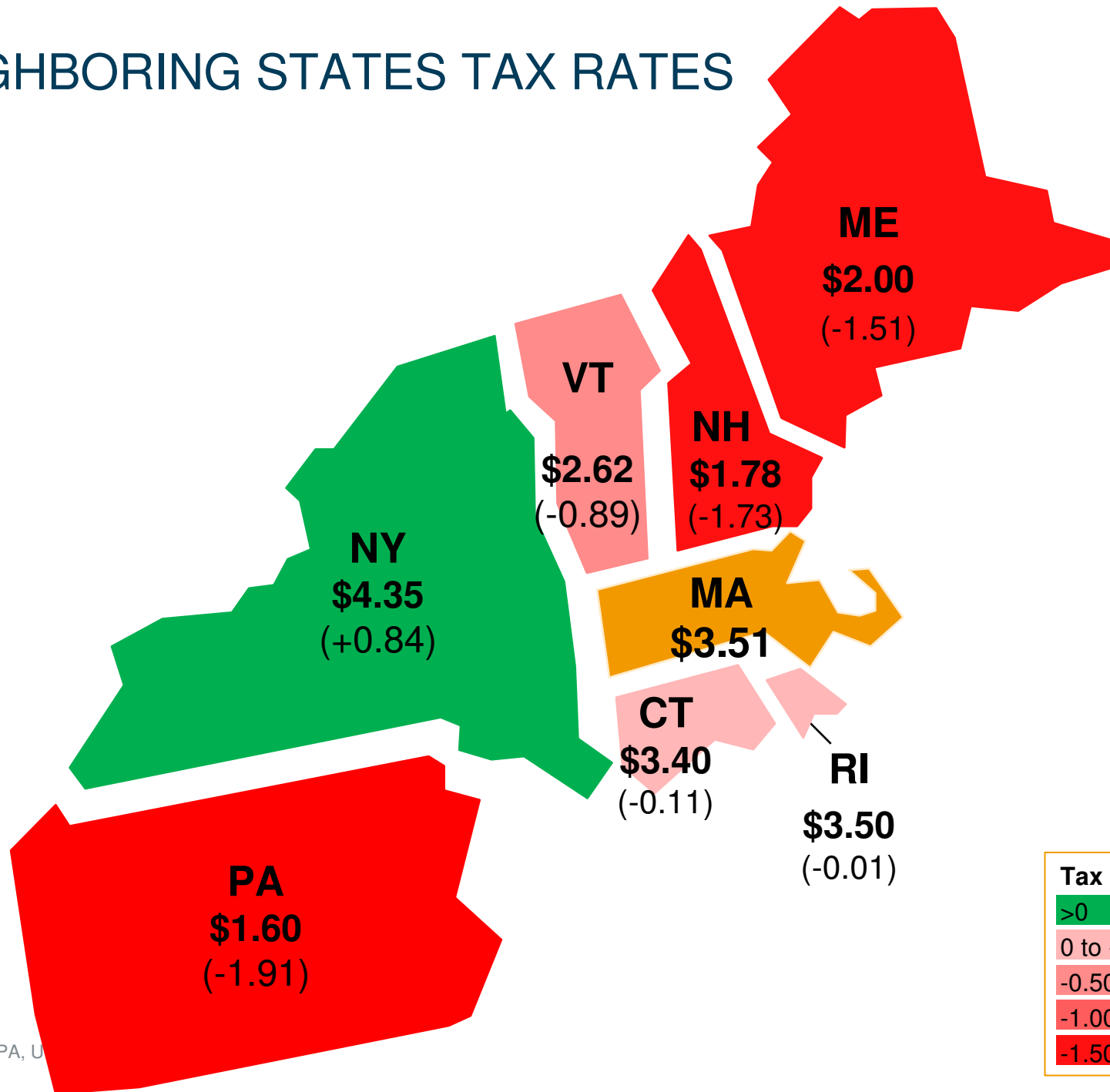
Volume in Millions of Packs



2003:
23rd largest volume

2012:
22nd largest volume

NEIGHBORING STATES TAX RATES



ILLICIT ACTIVITY // INCENTIVES

- All cigarette trafficking schemes, regardless of method, depend upon tax avoidance
- Increase in cigarette tax rates → increase in incentives for tax avoidance
 - Higher profit margins for the sale of an illicit pack of cigarettes
 - ▶ **Now higher than for cocaine, heroin, marijuana or arms trafficking**
 - Consumer willingness to buy at lower (less prohibitive) price increases
 - Limited fines and criminal charges
 - No significant changes to enforcement personnel or efforts

ILLICIT ACTIVITY // EXAMPLES

- Unstamped cigarette sale (Duty Free, Counterfeit, NC/SC/ND)
- Cigarettes stamped with another jurisdiction's stamp
 - Interstate smuggling (Smurfing or Large Scale) from low or no tax rate to higher tax rate, wholesale, retail, reservations
- Counterfeit cigarette tax stamps
- Non-reported / under reported cigarette sales (Sales and Corporate Tax)
- Under- or Non-declared Manufacturer, Native and Tribal production

ILLICIT ACTIVITY // TRACE SCHEMES

Illicit Trade Schemes Profit by Evading Taxes and Fees

RELATIONSHIP TO SUPPLY CHAIN	EXAMPLES OF ILLICIT TRADE SCHEMES	TAXES AND FEES AVOIDED			
		Customs duty	Federal excise tax	State/local excise tax	MSA/escrow payment
IMPORT	<ul style="list-style-type: none"> Smuggling genuine or counterfeit cigarettes into the United States Purchasing cigarettes from foreign Internet Web sites without appropriate payment of tax 	×	×	×	×
EXPORT	<ul style="list-style-type: none"> Diverting export-only cigarettes into U.S. commerce 	NA	×	×	×
MANUFACTURE	<ul style="list-style-type: none"> Manufacturing cigarettes in the United States without a license 	NA	×	×	×
WHOLESALE/DISTRIBUTION	<ul style="list-style-type: none"> Underreporting cigarette production to federal government 	NA	Paid	×	×
RETAIL	<ul style="list-style-type: none"> Purchasing tobacco products from retailer in one state for illegal transportation and resale in another state Purchasing cigarettes in Indian country for resale to nontribal members Purchasing cigarettes from domestic Internet Web sites without appropriate payment of tax 	NA	Paid	×	×
OTHER	<ul style="list-style-type: none"> Underreporting cigarette sales to MSA states 	NA	Paid	Paid	×

Source: GAO analysis

Note: In some wholesale/distribution and retail schemes, state excise taxes are paid in the state where the tobacco products are purchased, but unpaid in the state where the tobacco products are illicitly resold.

ILLICIT ACTIVITY // MASSACHUSETTS CONCERNS

- @\$3.51 / pack, MA has the 2nd highest cigarette tax rate in the U.S behind New York State.
 - **60%** of cigarettes consumed in NY (highest cig tax rate) are smuggled (estimation from Tax Foundation, 2011)
- The July 31st tax increase shown some impacted excise tax collection:
 - 15% drop in cigarette tax stamp sales in MA in August and October '13 when compared with 2012 – not a trend but should be monitored
 - Bordering cities have reported an increase in cigarette sale volumes
- In addition to lower excise tax revenue collection, there are other areas impacted by tax avoidance
 - Impacts MSA payments
 - Sales tax payments
 - Incentive for illicit actors to divert product from nearby states



III. BEST PRACTICES

BEST PRACTICES OVERVIEW

Tax avoidance is
unavoidable



Able to limit the degree of
tax avoidance



Requires a comprehensive,
multi-faceted approach

REGULATIONS

**ENFORCEMENT
TOOLS**

PENALTIES



III.A. BEST PRACTICES // REGULATIONS

BEST PRACTICES // REGULATIONS

- **Control of and visibility into supply chain – SICPATRACE®**
 - Data capture at the time of stamp application done by the Commonwealth
 - All data collected is owned by the Commonwealth
 - Maintenance of authorized Tobacco Product Directory
 - Automated capture and electronic filing of required forms and reports (expansion)
- **Licensing Requirements**
 - Enabling legitimate distributor and retailer market
 - Robust permitting and licensing requirements with minimum renewal periods
 - License revocation for any type excise tax avoidance (Zero Tolerance)
 - Background check for license applicants

BEST PRACTICES // REGULATIONS

- **Incentivize Prosecution**

- Increase criminal code classifications for first and repeat offenses

- **Enhanced Coordination**

- Coordination with other agencies and local law enforcement within the Commonwealth and I-95 corridor jurisdictions (e.g., NW3C, NESPIN, RISS, ROCIC)

- **Product and Revenue**

- Consumer perception of replacement products due to tax changes (e.g., RYO and Pipe)
- New products that do not have physical presence of tobacco leaf
- Data capture through continued enhancement of electronic reporting and filing (FTA Uniformity, TX HB11)



III.B. BEST PRACTICES // OVERSIGHT & PENALTIES

BEST PRACTICES // OVERSIGHT & PENALTIES

The number of overall seizures for the past three years has dropped significantly because of the enforcement presence and encrypted stamps.

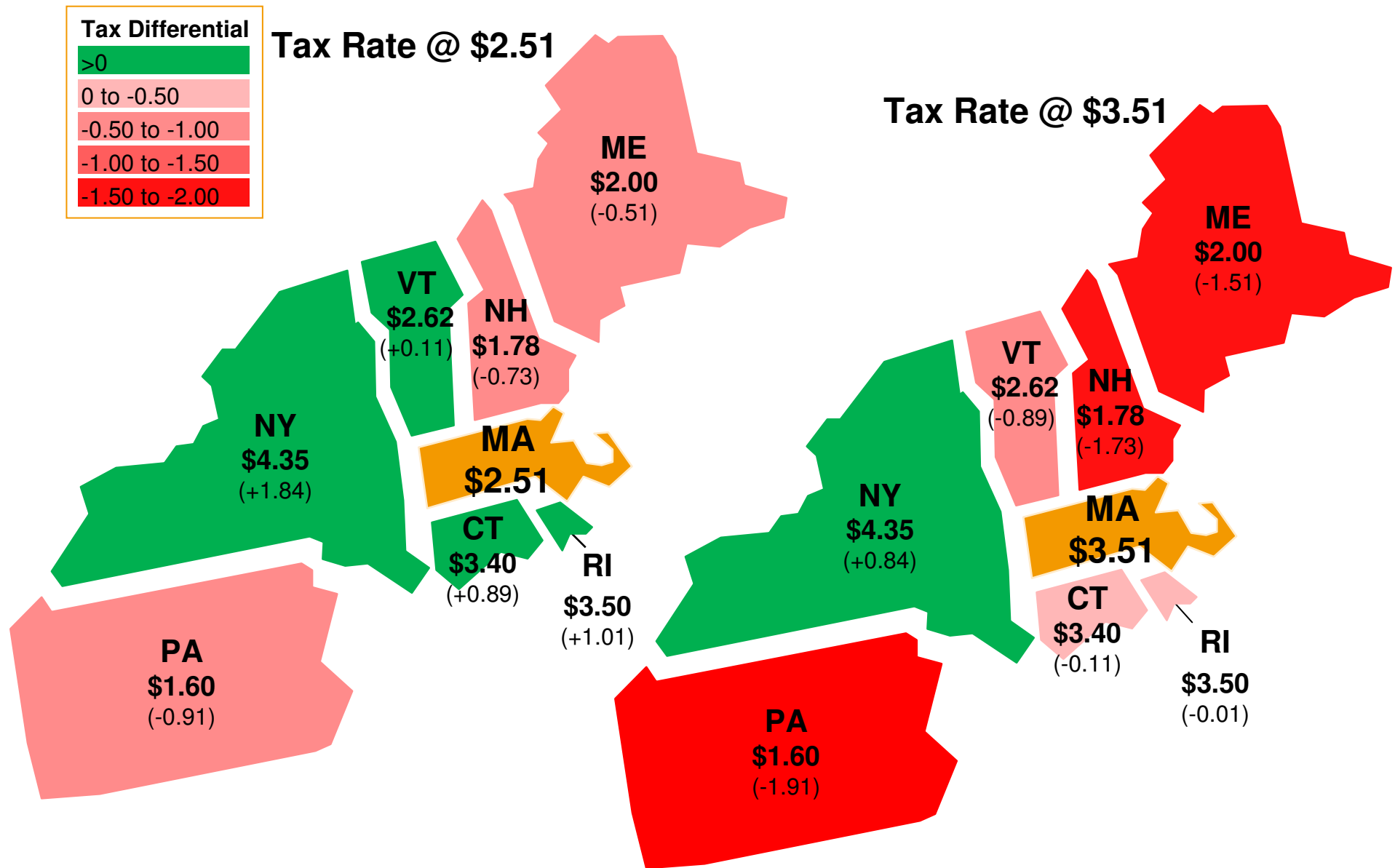
-Joe McDermott, Deputy Commissioner of Audit, November 7, 2013

- **Enforcement oversight - SICPATRACE®**
 - Ability to validate stamp audit results in real-time
 - Locational visibility for audit activity
 - Cross-tax reconciliation and auditing (e.g., Excise vs. Sales)

- **Increase # of enforcement personnel**
 - Dedicated tobacco unit
 - Train law/criminal enforcement on seriousness of illegal cigarette trafficking

- **Increase Penalties** (i.e. VA Crime Commission)
 - Possession of stamped product with intent to distribute
 - Possession of unstamped product
 - Forfeiture of property used in connection with cigarette trafficking

BEST PRACTICES // AUDIT PATTERNS





II.C. BEST PRACTICES // ENHANCED ENFORCEMENT TOOL // SICPATRACE®

SICPATRACE® OVERVIEW // COMPONENTS

ENCRYPTED
COUNTERFEIT
RESISTANT
STAMP



AUDITING
TOOLS



DATA
MANAGEMENT
SYSTEM



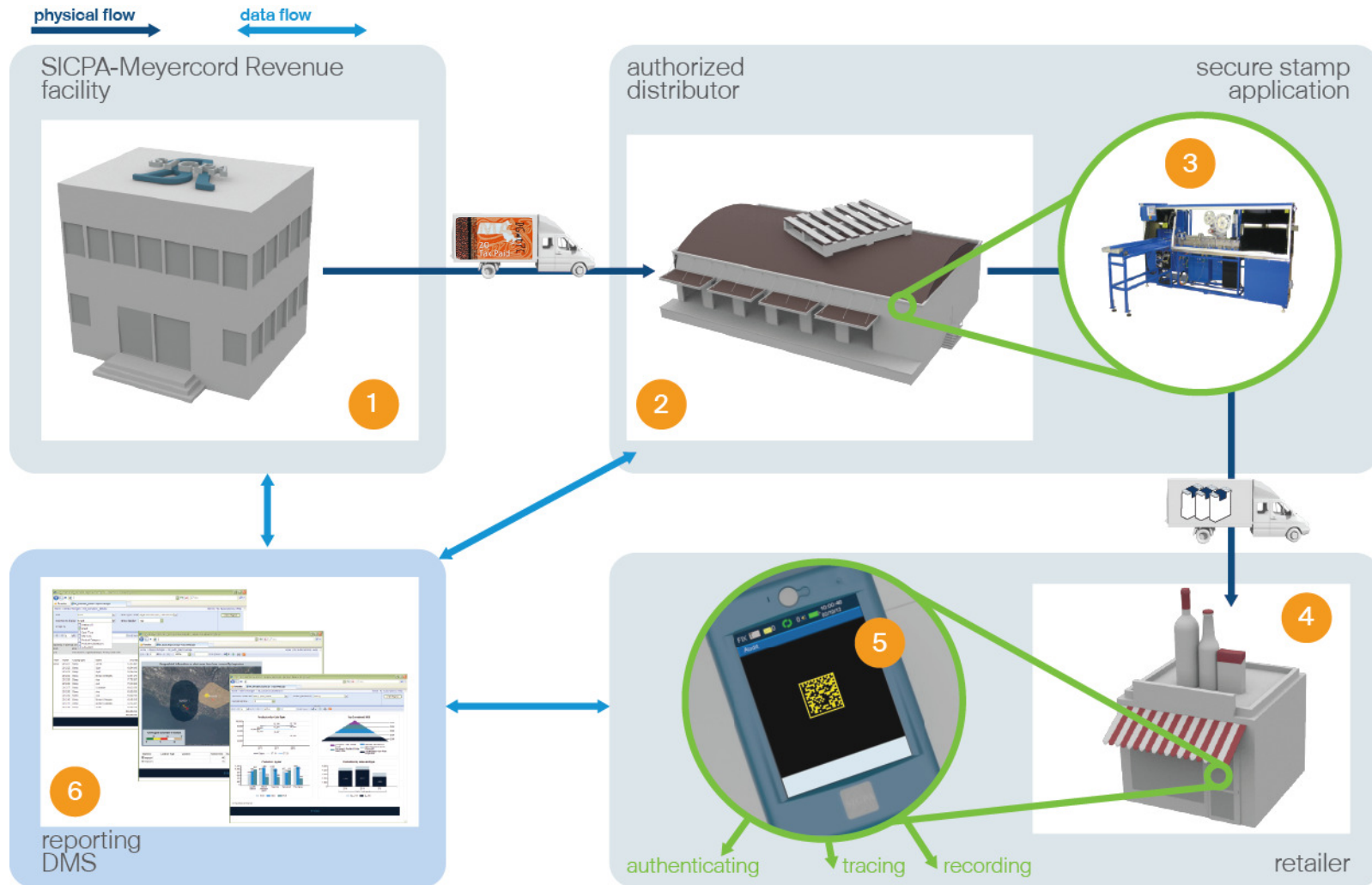
REPORTING
CAPABILITIES



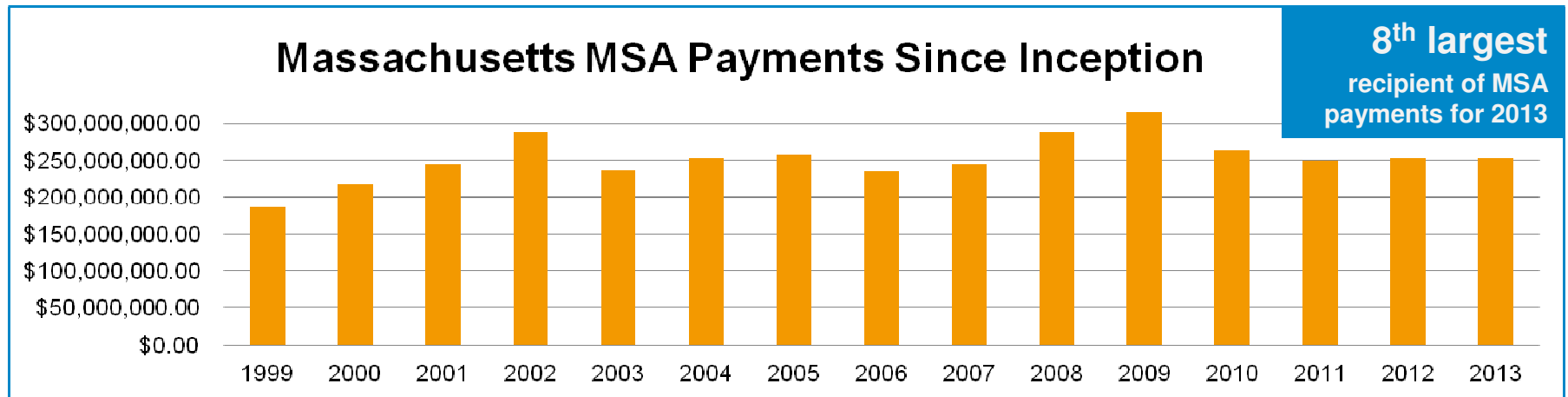
SICPATRACE® BENEFITS

COMBATING ILLICIT TRADE	unparalleled level of physical- and information-based security
PROTECTING MSA PAYMENTS	more accurate reporting of cigarette sales by type and manufacturer
MAKING EFFECTIVE DECISIONS	more efficient and targeted reporting generated from enhanced field audit tools
PROTECTING PUBLIC HEALTH	reduces the proliferation of counterfeit products enables more revenues to be used for tobacco cessation programs
SECURING THE SUPPLY CHAIN	visibility into and control over tobacco distribution channels

SICPATRACE® OVERVIEW // PROCESS



BEST PRACTICES // SICPATRACE® BENEFITS PROTECTING MSA PAYMENTS



Example of failure to diligently enforce:

Pennsylvania, the 5th largest recipient of MSA payments in 2013, stands to lose **\$180 MILLION** (60% of the state's 2014 MSA payment) due to recent arbitration ruling related to non-participating manufacturers (NPM) and reduced market share for participating manufacturers (PM).

<http://gantdaily.com/2013/10/03/administration-notified-about-tobacco-master-settlement-agreement-arbitration-panel-decision/>

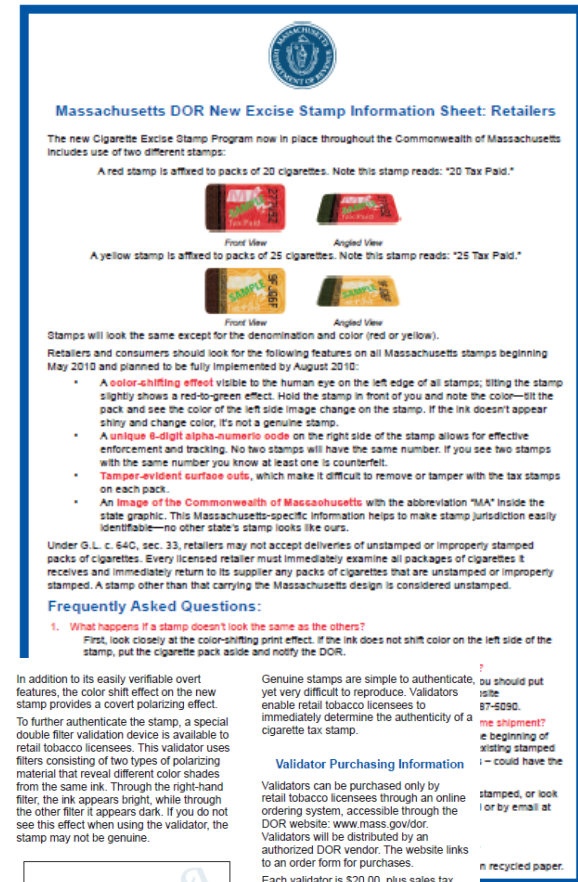
BEST PRACTICES // SICPATRACE® BENEFITS

KEY STAKEHOLDER SUPPORT

- 24x7 Operations and Customer Service organization, monitoring in real-time, all field deployed modules (Stamp Manufacturing, Distributor Stamping, Field Enforcement and Data Generation)
- Proactive monitoring system to help identify and solve issues
 - Reacts quickly, sometimes even before the user knows there is an issue
- Minimizes downtime for distributors and ensures integrity in supply
- Supports Field Enforcement reviews and drives with data

BEST PRACTICE // COMMUNITY OUTREACH PROGRAM

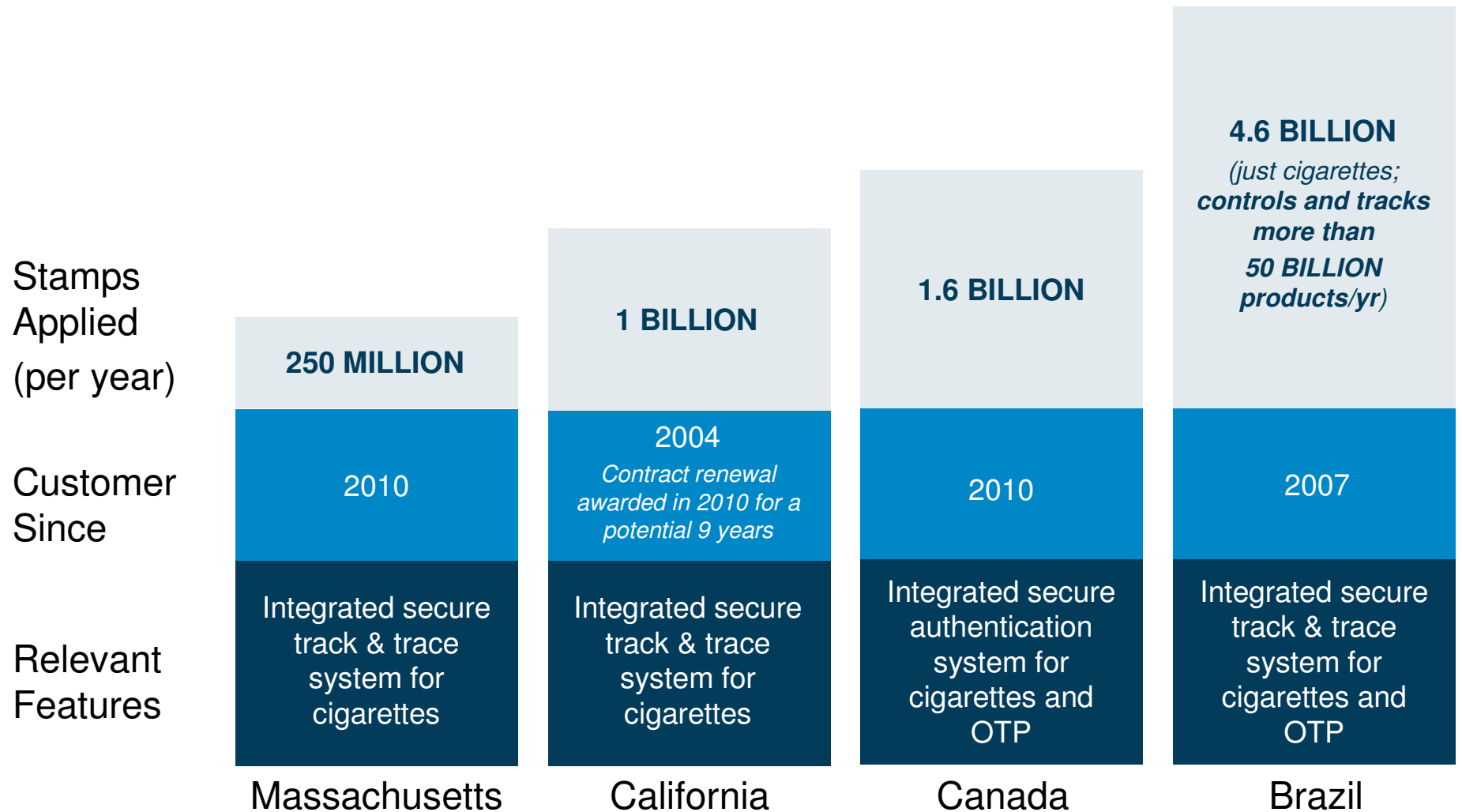
- Joint preparation of educational materials for retail locations and consumer outreach
 - Stamp information sheet for distributors
 - validation device fact sheet for retailers
- Cost effective stamp validation tool (VA-11) to retail outlets and distribution partners available for purchase



Validators are specifically designed to match the color-shift feature on genuine cigarette tax stamps. This device provides retail tobacco licensees with a tool that is:

- Simple
- Practical
- Hand-held
- Easy to use
- Effective
- Small and light as a credit card
- Reasonably-priced

BEST PRACTICES // LEVERAGING OTHER DEPLOYMENTS





ADDITIONAL TOOLS FOR CONSIDERATION



III. MARKET TRENDS: LOOKING BEYOND CIGARETTES

MARKET TRENDS: LOOKING BEYOND CIGARETTES

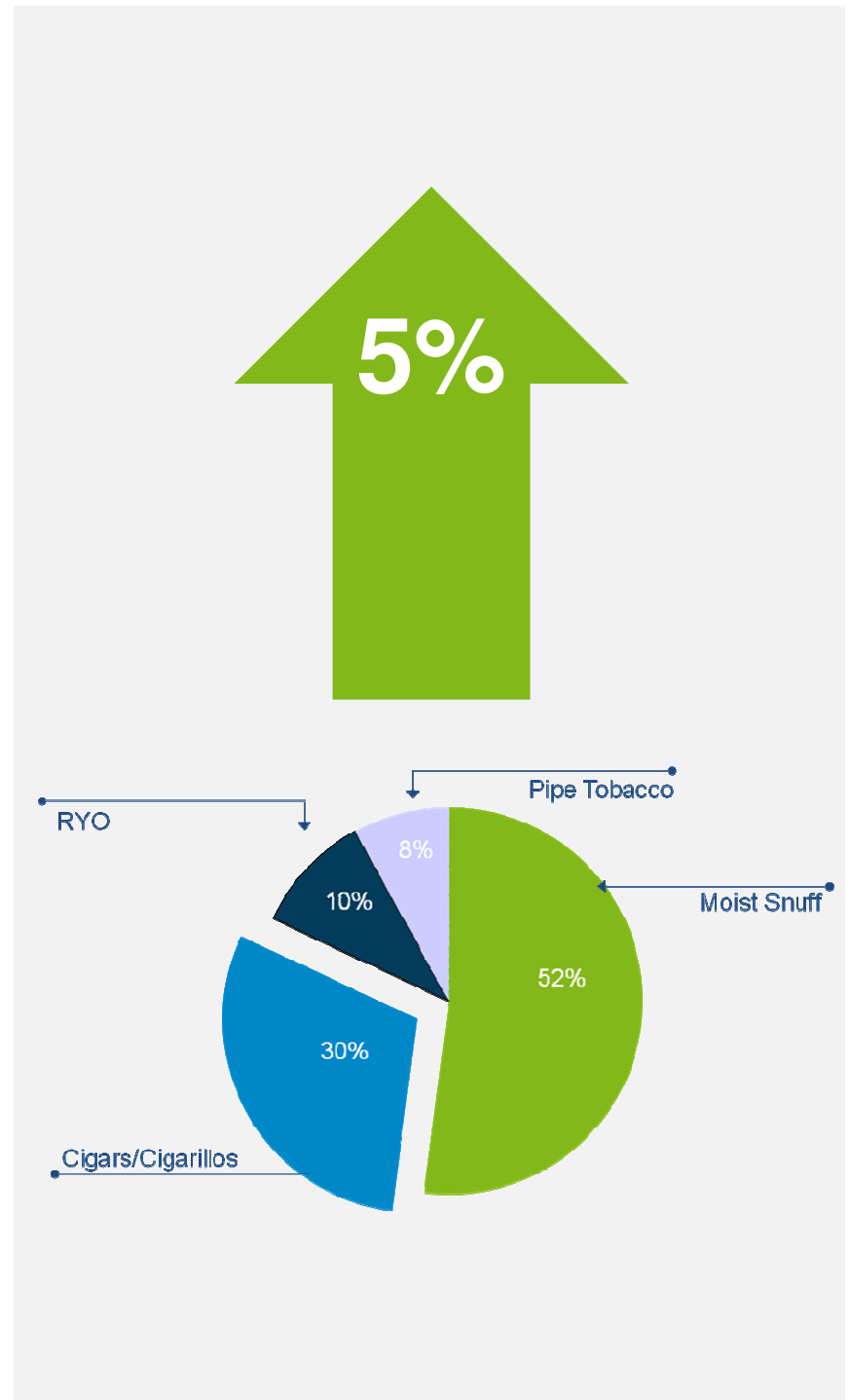
- According to American Wholesale Marketers Association (AWMA):
 - Cigarette volumes are down 2% year over year
 - Other Tobacco Products (OTP) and E-cigarettes are continuously growing YOY
 - ▶ E-Cigarette unit sales are growing by 234%
 - Retailers are allocating more space to key subcategories (OTP and E-cigarettes)
- OTP and E-Cigarettes are impacting cigarette sales
- States **MUST** establish regulations, including tax collection/control mechanisms and penalties, in order curb illicit trade in these up and coming markets

OTP – CONTINUED AND STEADY GROWTH

- OTP's annual revenue growth year over year is 5%
- OTP comes in many different shapes, sizes, flavors and prices
- OTP is often marketed as safer, cheaper, able to use in non-smoking environments, or more discreet than cigarettes

The average convenience store sold \$55,960 in OTP products in 2010, an 11% increase over 2009.

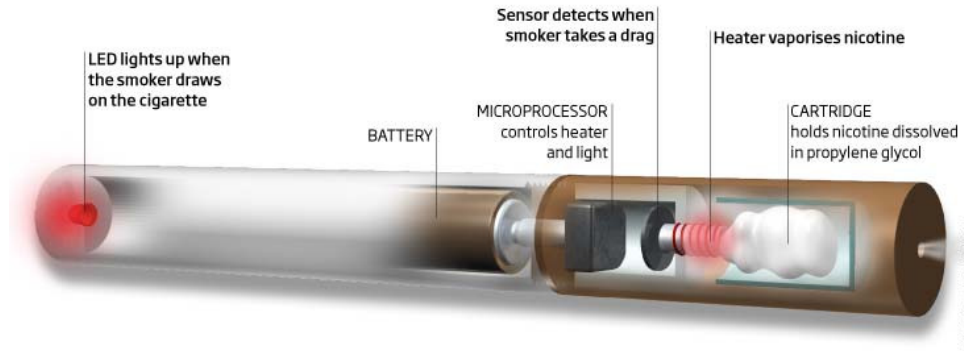
- Convenience Store News



E-CIGARETTES

Smoke without fire

Suck on an e-cigarette and it produces a cloud of nicotine-carrying vapour with none of the toxic by-products of burning tobacco



2.5

MILLION e-cigarette smokers (45 million total smokers in the U.S.)

\$1.50

cost of e-cigarette equivalent to a pack of cigarettes (\$8.77 in MA)

\$1.7

BILLION e-cigarette sales predicted in 2013 (\$500 million in sales in 2012; over 50% growth)

1

STATE to currently levy an excise tax on e-cigarettes (Minnesota taxes e-cigarettes as OTP)



II.D. BEST PRACTICES SUMMARY

BEST PRACTICES SUMMARY

Enhance Enforcement Efforts	✓
Upgraded enforcement tools – best-of-breed mobile reader SICPAMOBILE® SM45	✓
Dedicated tobacco unit	
Increase number of enforcement personnel	
Expand Regulations and Policy	
Increase penalties for offenders and deploy a stricter enforcement code (limit # of stamped cigarettes, increased penalties for unstamped cigs, lower quantity threshold and increase penalties for subsequent violations, property forfeiture used in connection with illicit activity)	
Support Key Stakeholders	✓
Proactive infrastructure monitoring and effective support	✓
Protect MSA Payments	✓
More accurate and better reporting of MSA information	✓
Continuous Improvement	✓
Improving stamp security – SICPATRACE® multi-layered counterfeit resistant stamp	✓
Implementing lessons learned from similar deployments	WIP
Improving reporting platform – SICPATRACE® reports	✓
Expand Excise Tax Program	
Expand program to products such as OTP and e-Cigarettes	
SICPATRACE® can support a multi-product platform	✓
Expand program to include invoice capture/e-reporting	

QUESTIONS?



THANK YOU
FOR YOUR ATTENTION



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